U.S. Economy Moderates in 1997

The U.S. economy had a strong showing in 1996 and the first half of 1997 with low unemployment and low inflation. Continued moderate economic expansion is expected to benefit rural areas due to growth in employment and higher real wages.

The United States finished its fifth year of economic expansion with few signs of weakness outside of the trade sector. The Federal Reserve responded to the general weakness in the economy in late 1995 and early 1996 by lowering the Federal Funds rate—the overnight rate at which banks lend money to each other to cover reserve requirements—by 50 basis points; that is, 0.5 percentage points. As a result, the yield on 3-month Treasury bills averaged 5.0 percent in 1996, down from the 5.5-percent yield of 1995. The low interest rate and strong consumer and business spending resulted in increased Gross Domestic Product (GDP) growth. GDP growth for the year was a moderate 2.5 percent.

Despite a sharp surge in energy prices in 1996, accelerating inflation did not materialize. Crude oil and industrial natural gas prices both rose 35 percent from November 1995 to November 1996. This energy price increase coupled with sharp food price increases triggered a 2.5-percent rise in producer prices—up from the 1.7-percent rise of 1995. Nevertheless, broader inflation did not accelerate and consumer prices rose at only a 2.9-percent annualized rate, up only slightly from the 1995 rate of 2.8 percent. In fact, the GDP deflator—a measure of inflation over the entire economy—rose only 2.1 percent, down from the 2.5-percent rise of 1995.

The Labor Market Continued To Tighten Throughout 1996

The unemployment rate steadily dropped over the year, with an annual rate of 5.4 percent; 2.8 million more workers were employed at the end of 1996 than at the end of 1995. The labor force grew by 2.6 million as individuals joined or rejoined the labor force. The labor force participation rate increased as a larger share of the population was in the labor force. Several regions were reporting tight labor markets. Real wages unambiguously increased for the first time in the recovery from the recession that began in summer 1990 and ended in early 1991. However, they did not match recent productivity gains. The real wage increases allayed concerns at the beginning of the year that consumer spending would soften.

Low Unemployment, Low Inflation, and the Federal Reserve

The joint good news of low unemployment and low inflation has surprised analysts for the last year. Typically, as unemployment declines, labor markets tighten and wages are bid up. Larger wage increases historically have triggered rising inflation since wages and benefits are the largest component of business costs. The Federal Reserve looks closely at unemployment rates as an indicator of labor market tightening in monitoring inflationary pressures.

The Federal Reserve refrained from raising the Federal Funds rate over 1996 despite the declining unemployment rate. However, inflation did not accelerate. One reason is that overall real compensation increases have been less than productivity gains (fig. 1). Employers could afford to pay slightly more for workers because they were producing more. Another part of the story is that some labor markets—regional markets such as the Midwest and specific occupational markets such as the one for computer specialists—have experienced noticeable wage increases, but others, such as manufacturing, have not. Average real wage increases over the economy were small but, for the first time in the recovery, were positive by all measures.

1997 So Far and Outlook

The U.S. economy experienced spectacular real GDP growth in the first quarter of 1997, at an annualized rate of 5.9 percent—an increase of $101 billion. Fueling the first-quarter growth was an increase in real consumer spending of 5.6 percent, led by a nearly 19-percent increase in spending on consumer durables. Mild weather played a large role in boosting consumer durable spending. Business fixed investment also had a strong showing with an annualized increase of 11 percent. Business inventory accumulation added $31 billion to real GDP. Unemployment continued to decline and inflation was low.

Economic growth is expected to moderate from the very fast pace of the first quarter. The combination of low unemployment and low inflation will likely continue, although monthly inflation and unemployment rates will be somewhat higher in the second half of the year. Moreover, the trade deficit is expected to increase with a sharp increase in demand for imports largely to meet growth in the demand for nondurable goods. This increased import demand is largely due to a delayed reaction to a higher valued U.S. dollar in 1996.

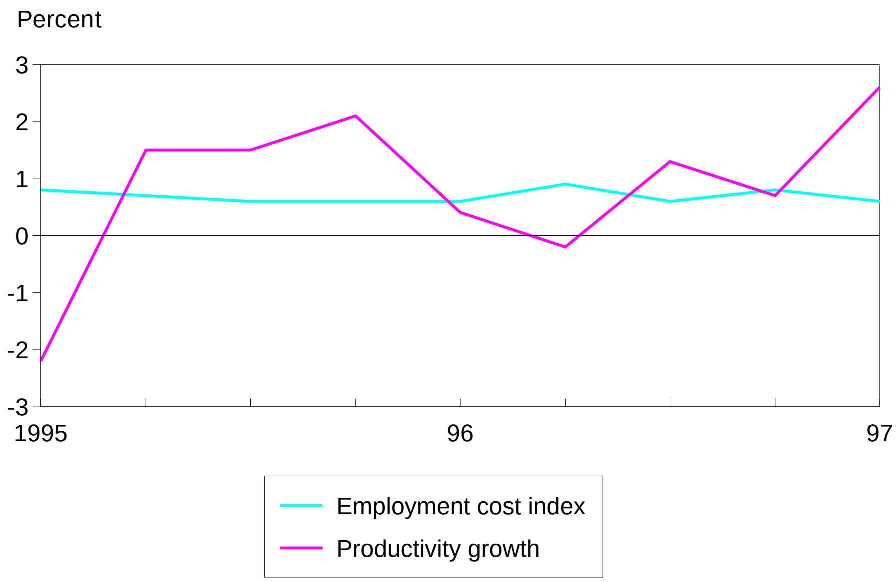
The prospects for continued low inflation are excellent. The producer price index fell January through May. The 2.6-percent growth in nonfarm labor productivity in the first quarter, the modest recent increases in the Employment Cost Index, and recent high profit levels mean that employers can well afford moderate real wage increases. The tighter labor market will almost ensure that higher wages will have to be paid. Although capital utilization rates have increased recently, they are far from levels that will trigger high inflation.

The unemployment rate will continue to be relatively low through the year, although GDP growth will moderate. The tight labor markets will result in higher real wages. Good disposable income growth from increased real wages will support consumer spending growth. Larger consumer spending on services and nondurables such as clothing and food will mainly drive the moderate GDP growth. In addition, exports are likely to be strong over the coming year. Foreign demand for U.S. products is expected to increase as trading partners' GDP growth improves. However, the strong consumer demand, in the context of a strong U.S. dollar, will also fuel increased imports, so the net trade deficit is expected to increase somewhat, thus moderating GDP growth.

Figure 1

Productivity growth and compensation cost growth

Productivity growth has exceeded compensation cost growth over most of the last 2 years



Source: Employment Cost Index for compensation, all civilian workers, seasonally adjusted, 3-month percent change; and output per hour, nonfarm business, seasonally adjusted, percent change from previous quarter at annual rate, from Bureau of Labor Statistics.

Growth in Manufacturing and Exports To Benefit Rural Areas

The Federal Reserve raised short-term interest rates in March to prevent a surge of inflation in 1998, and may raise them again later this year. But long-term interest rates are likely to average about what they did in 1996. Since U.S. interest rates are relatively high compared with Germany and Japan, the dollar will remain strong throughout 1997. Banks appear to have plenty of money to lend at relatively low rates, supporting small manufacturers, rural service businesses, and farming.

Manufacturing, which had strong growth in 1996 and early 1997, will moderate in the second half of 1997 as domestic growth slows. This moderate growth should benefit rural areas since manufacturing is an important employer of rural workers. The unit labor costs of American manufacturers, even at the current value of the dollar, are lower than those of Japan and Germany (except for vehicles and vehicle parts).

ERS research suggests that rural areas are more export-dependent than urban areas, so the robust demand for U.S. exports should result in a favorable employment situation in rural labor markets. Although not as high as in 1996, farm income will be quite good in 1997. The rural service sector, particularly that supporting agriculture, should be strong. The expected continued tightness in the service and manufacturing labor markets and the scheduled boost in the minimum wage should result in higher real wages in rural areas in 1997. *[Data as of July 1, 1997. David A. Torgerson, 202-501-8447 (after October 31, 202-694-5334), dtorg@econ.ag.gov; and Karen S. Hamrick, 202-219-0789 (after October 24, 202-694-5426), khamrick@econ.ag.gov]*